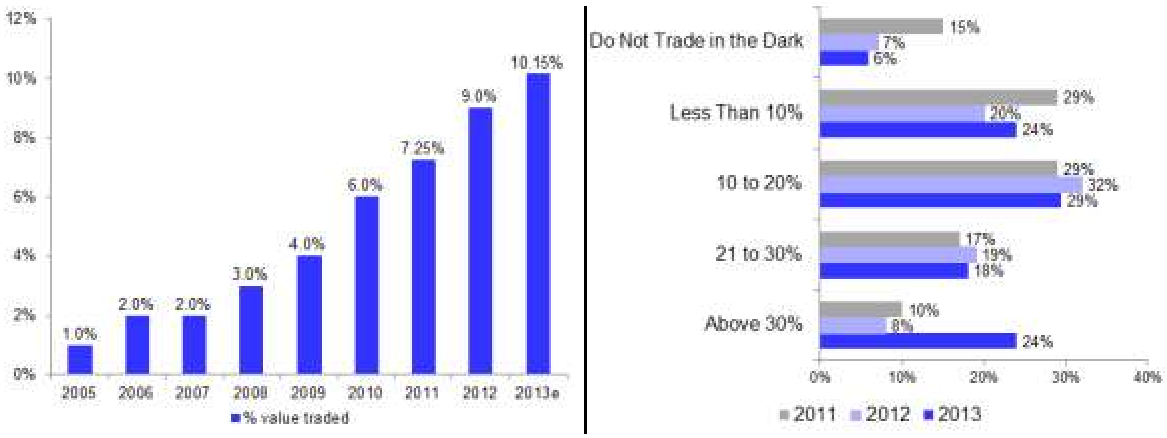
Dark Matters

Rebecca Healey | V11:037 | September 2013 | www.tabbgroup.com

Executive Summary

European dark volumes have now reached in excess of 10% of equity trades. Only 6% of asset and fund managers interviewed do not trade in the dark, versus 15% in 2011, and those who do trade have increased their participation levels (see exhibits 1 and 2).

Exhibits 1 and 2
Current European Dark Volumes / Percentage of Order Flow Executed in the Dark

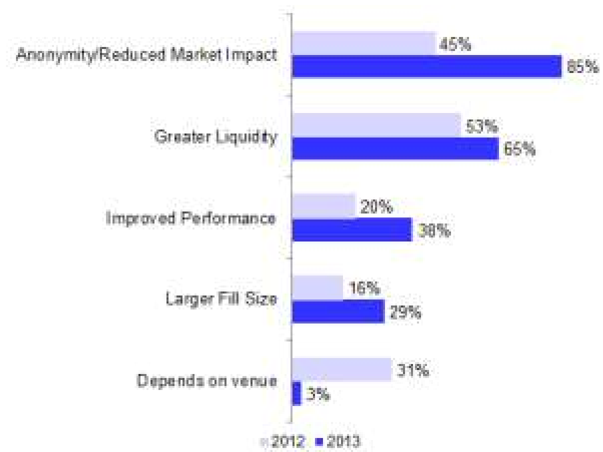


Source: Thomson Reuters Equity Market Share Reporter (EMSR)/TABB Group

With the increase in volumes traded away from the primary exchange, European politicians perceive a need for greater supervision of dark venues. Proposed regulation to impose a volume cap on the reference price waiver, together with the introduction of a restricted Organised Trading Facility (OTF) will, they believe, limit trading in non-transparent markets and return volumes onto exchanges, enabling investors to detect a credible price signal.

However, there is no guarantee that this will happen. As exchanges have moved from a mutualised to for-profit model, their need to attract market participants creates a greater conflict for asset managers executing institutional order flow. Initiatives to facilitate market-making flow can attract short term-investors that may be damaging for institutional activity. Displaying the asset manager's intentions before they can execute enables shorter-term investors to profit ahead by trading against institutional investors. Poor execution impacts fund performance; as a result, 85% of the buy-side participants interviewed now actively select alternative liquidity pools away from primary exchanges in their hunt for anonymity and reduced market impact (see exhibit 3).

Exhibit 3
Why Buy Side Traders Execute in the Dark



Source: TABB Group

There is a real danger that the proposed regulation will shift institutional order flow to further obscurity via over-the-counter (OTC) phone trading or even to new order types, such as the increased use of negotiated trade waivers seen in Italy. Politicians may want greater transparency but by trying to push all order flow onto primary exchanges, they will harm the very pension funds and retail investors they claim to want to protect.

What is Dark Trading?

Dark trading is trading away from the primary exchange. Sellers are connected to buyers allowing them to match orders without exposing their intentions to the public ahead of execution. This ensures they can achieve optimal price improvement without moving the market price adversely due to their larger order sizes.

Dark trading is not new; OTC block trading has always taken place. However, whereas traditional OTC activity was a negotiated bilateral trade between buyer and seller (via a broker as intermediary), automated dark venues and brokers are now able to systematically match orders by internalising order flow electronically.

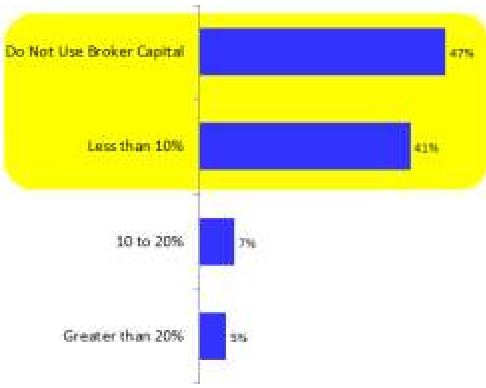
The often-cited figure of 40% of OTC activity is not just dark trading volume. It is volume traded away from the exchange, but it encapsulates a wide range of trade types, some of which do not necessarily constitute "interactable" liquidity – in other words, liquidity that the buy side can execute against. Technical trade reports, which are required under European trade reporting rules, are also included within this OTC activity.

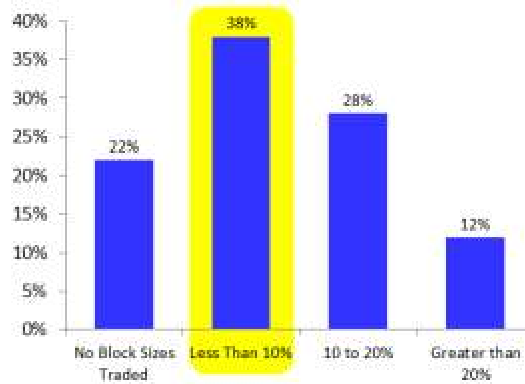
Trades that are interactable but traded OTC are also more opaque than trades executed electronically in the dark. Automated trading in alternative liquidity pools now offers greater post-trade transparency through the use of Financial Information eXchange (FIX) tags that can track the progress of an order throughout the execution. This information can then be used for pre-trade venue selection.

Changing Market Structure

The potential to encounter signalling risk and therefore reduced performance meant that historically asset managers chose to execute institutional order flow by negotiating a pre-determined price and size with their broker.

Exhibits 4 and 5
Decline in the Use of Risk Capital / Percentage of Order Flow Traded as a Block





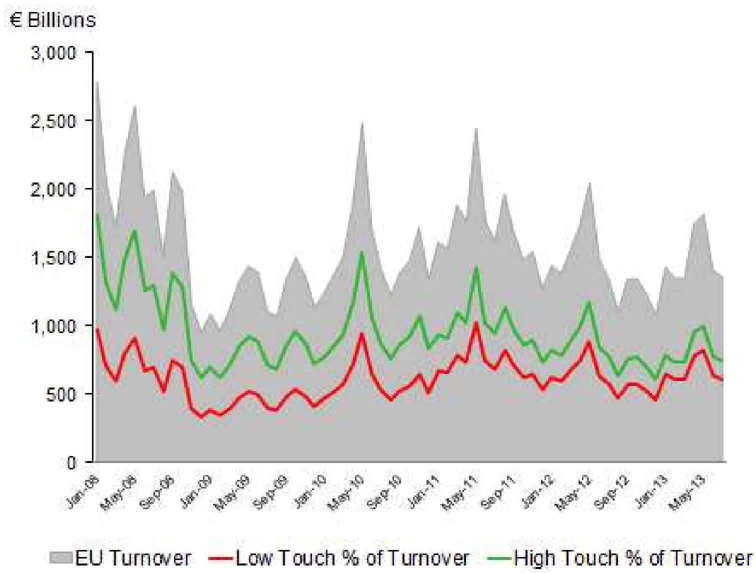
Source: TABB Group

Reduced margins, bank deleveraging and stricter capital requirements limit the ability for brokers to offer risk pricing to any other than their top clients, impacting the buy side's ability to trade in blocks (see exhibits 4 and 5).

The demise of block trades has coincided with a decline in overall equity trading volumes as a result of wider European regulation and lower investment returns. This has high-lighted market structure inefficiencies and exacerbates the ability to execute large-in-size orders typical of institutional investors.

Consequently, investors are choosing to automate their order flow and trade in smaller "retail-sized" orders to be indistinguishable within the reported trading volumes. As overall European equity trading turnover has decreased, the proportion traded electronically (or low touch) has risen versus the proportion traded "high touch" via a sales trader (see exhibit 6). The alternative is to actively access alternative liquidity pools. Many on the buy side see improved execution results using alternative liquidity pools, where they can aggressively trade when they find liquidity at the right price, rather than stepping up and trading in size.

Exhibit 6
The Rise in Automation



Source: Thomson Reuters EMSR/TABB Group

As firms begin to automate the investment process, changes to the management of portfolios require alternative execution strategies; nuances are now regularly made to portfolios to tweak percentages, notional values or sector weightings. Risk-adverse portfolio managers, nervous of showing their full hand, are choosing to split orders up in the hope they average out, rather than risk buying or selling at the wrong level. As a result, very different order flow is now reaching buy-side trading desks, creating further complications for institutional trading.

Greater index benchmark trading and market-on-close activity can make the market more volatile in certain periods of trading. In turn, this plays into greater risk adverse strategies, creating a requirement for further automation and increased use of alternative liquidity pools in order to limit information leakage ahead of trade execution.

If trading the underlying equity becomes increasingly restricted and complicated, institutional investors will continue to look towards new products such as contracts for difference (CFDs) and other derivatives products, as we have witnessed recently in Europe as a consequence of the financial transaction tax introduced in France and Italy.[1]

[1] TABB Group, *European Equities Market: 2013 Mid-Year Review*

Benefiting Small and Mid-Caps

Protecting European pensions and fledgling small and mid-cap stock performance has never been more critical. However, the recovery story will not necessarily be aided by forcing trading onto primary exchanges.

The ability to hide within trading volume when executing small and mid-cap stocks does not exist; these companies are traded infrequently in comparison to a large-cap stock. However, accessing alternative liquidity pools enables investors to enter or exit an investment strategy in a low-cap stock with minimal market impact. Despite the controversy, buy-side firms will continue to seek sanctity in the alternative liquidity pools for small and mid-caps in particular. The growing reliance on electronic market makers to facilitate trading when in fact large-cap market share (and in particular that for small and mid-cap stocks) is only shrinking, highlights the challenges in executing anything other than a large-cap stock and therefore, the future of investibility of Europe.

Improving Pension Fund Performance

There is also a perception that small orders are damaging for price formation. However, institutional investors may choose to trade a small (child) order as part of a larger (parent) order, rather than executing one-share orders to "ping" the market. By trading smaller sections of a larger order surreptitiously, the buy-side trader is able to maintain price performance and not inadvertently move the market. The alternative – forcing smaller orders onto lit exchanges – will make small caps more expensive, drive the need for exchanges to offer price rebates as there is less incentive to facilitate market making, and will make the marketplace overly complex.

The break-up of parent orders will continue as the responsibility for order execution shifts from the sell-side broker to the asset manager's execution desk, due to greater automation, the economic downturn and increased fiduciary responsibilities regarding "best execution".

Methodology

This research looks at the rise of dark trading, its increasing influence on the current equity trading environment, and possible improvements that could be made to increase transparency, without inadvertently impacting liquidity. Our findings are based on 94 interviews conducted during the past year with institutional asset managers trading European equities. Between them, these respondents have worldwide assets under management (AUM) of more than €14.2 trillion.

TABB Group, which was founded in 2003, is a global financial market research firm that conducts research based upon an interview-driven methodology. For the purposes of validating the research conducted, interviewees were carefully selected to ensure a clear "voice of the market", with one-on-one detailed conversations concerning the current challenges facing European market participants.

Recommendations

Trading via alternative liquidity pools is on the increase. This should not pose a problem, provided this avenue of execution allows asset managers to achieve improved pricing for institutional order flow.

However, there is more that can be done to improve transparency within alternative liquidity pools and although significant progress has been achieved, room for improvement remains. The buy side would welcome better insight into market activity.

To achieve this transparency, TABB Group recommends the following processes be implemented prior to additional regulation of alternative pools, which could inadvertently damage liquidity and the ability to execute institutional order flow in the process:

1. **A mandated consolidated tape with harmonised reporting standards.**
   FIX tags such as 28, 30 and 851 will eventually create greater transparency as to the trading behaviour of individual venues against individual stocks. What will become increasingly important will be creating a similar level of transparency for phone/voice-order execution as for automated/algorithmic trading.

2. **Calibrated transparency requirements for large, mid and small-cap stocks.**
   By developing market-specific benchmarks (based on spreads and/or volumes traded, for example) rather than blanket legislation, the accuracy of price formation can be better assessed, and more effective decisions can be made pre-trade. In particular, a recalibration of the Large In Scale waiver to more practical levels based on average daily volumes (ADV) traded or nominal market size (NMS) would benefit institutional trading.

3. **Retention of the equity OTF but with limited and simplified categories and order types.**
   The simplification of market structure will ensure clarity of the rules and should include standardisation of client facilitation of order flow, restrict onward routing, and ensure the minimal number of order types.

4. **Ensure flexibility within the rules by basing these on technical guidelines via a pilot scheme, delegated to the European Securities and Markets Authority (ESMA).**
   With a focus on prevention rather than cure, improved data standards will increase robust monitoring and more effective supervision.

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Regulation and the Consequences

More than three-quarters (76%) of buy-side traders believe that increased regulation of alternative liquidity pools will negatively impact European equity trading (see exhibit 7). The primary concern of almost 60% of participants is the increased complexity and cost of trading, whereas nearly 40% are now more concerned with their ability to interact with small and mid-cap stocks (see exhibit 8).

Exhibits 7 and 8
The Impact of Future European Regulation / Top Buy-Side Concerns

Source: TABB Group

Article 20c: the Obligation

"Whatever happens, the regulators need to make sure they can change the rules, in order to avoid the impact of unintended consequences – look what has happened in Italy." (Continental Medium-Sized Asset Manager)

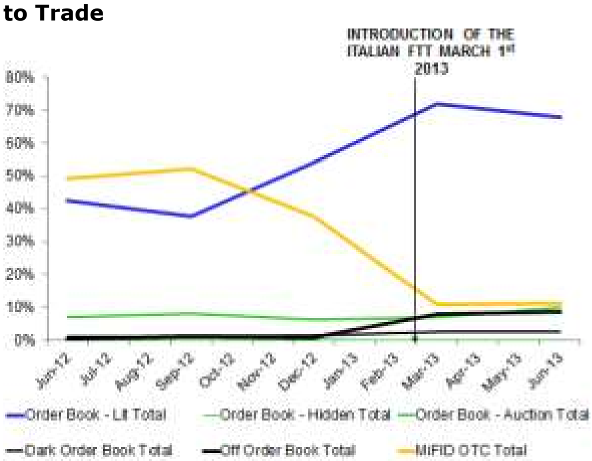
Under article 20c of Markets in Financial Instruments Regulation MiFIR, the majority of trading should be conducted on regulated venues and be fully transparent, both pre and post trade. Investment firms must undertake all trades (including trades dealt on their own account and dealt when executing client orders) on a regulated market via a multilateral trading facility (MTF), OTF or systematic internaliser (SI), unless trades are "are non-systematic, ad hoc, irregular and infrequent, or are carried out between eligible and/or professional counterparties and do not contribute to the price discovery process".

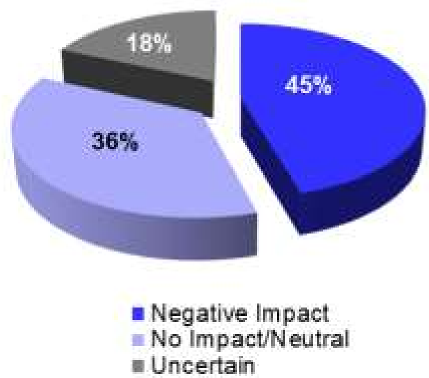
ESMA has been tasked with drafting regulatory technical standards specifying the particular characteristics of those transactions in shares that do not contribute to the price discovery process (non-addressable liquidity trades), or where the exchange of shares is determined by factors other than the current market valuation of the shares.

The hope is that if liquidity were forced back onto the lit markets, price discovery and liquidity would be easier to access. Given the market's response to restrictions in trading Italian equities OTC, this seems optimistic.

The introduction of a higher rate of tax for OTC transactions in Italy and the narrower scope of market-making exemptions are fuelling significant behavioural changes in Italian market structure. OTC trading declined from 49% to 11% in a year. However, the number of off-order book trades increased from 0.57% to just below 9% (see exhibit 9). In addition, overall liquidity volumes halved.[2]

Exhibits 9 and 10
Italian Equity Turnover by Order Type, June 2012–2013 / The Impact of Article 20c on the Ability to Trade





Source: Thomson Reuters EMSR/TABB Group

"My concern is the lack of tight definitions of what systematic means will be abused by the sell side to the detriment of investors."
(Large-Sized UK Asset Manager)

Institutional investors require the ability to transact and undertake trade reporting on a wholesale basis on behalf of their customers. A market structure that reduces their ability to do so impacts end-clients – mainly pensioners – negatively. SI is a highly specialised subset of OTC trading, and the low take-up on SI in MiFID I illustrates that, as it stands, the SI category is not perceived by institutional investors as a beneficial method of order execution.

Participants are as yet undecided as to the impact of this regulation (see exhibit 10). Much depends on how well defined and accessible the SI and OTF categories become. If participants can still trade "OTC" under an SI regime and the OTF acts like a proprietary-free broker crossing system (BCS), then the changes will be positive. If brokers are unable to continue with the current execu-

[2] *Ibid.*

tion options, then liquidity for institutional order flow will become further hampered.

Substantial differences between the European Council and the European Parliament's versions of the text remain. The current definition under the EU Parliament MiFIR text (October 2012) effectively creates a super-concentration rule:

"Very often, we're not able to trade in the lit market due to our order size, so we use the dark, frequently."
(Large-Sized European Asset Manager)

a) Any product that does not fall within the narrow "OTC definition" must be traded on a venue; and
b) Any product that does fall within the "OTC definition" must be traded on an SI.

The latter requirement also raises the issue of how products that do not trade under the current definition of OTC – frequent, organised and systematic in manner (which is the requirement to trade on an SI) – are to be transacted, since OTC trading off-venue is apparently not allowed.

The current OTF category under the European Commission's version of the Markets in Financial Instruments Directive MiFID II text will be virtually useless without the matched-principal option, as it will curtail available activity. The OTF category could potentially remain but with strict caveats over the type of flow, such as only allowing crossing at the midpoint and with no onward routing. Brokers might be able to offer this as a service but perhaps only if it enables price improvement.

Waving the Waivers

Proposed amendments concern two pre-trade transparency waivers currently allowed for equity markets in Europe:

- The **large-in-scale waiver** (LIS), which allows alternative liquidity pools to operate if orders are large blocks compared with normal market size;
- The **reference price waiver** (RPW), which allows alternative liquidity pools to operate if prices are matched at the midpoint of the best bid and offer spread of a primary exchange.

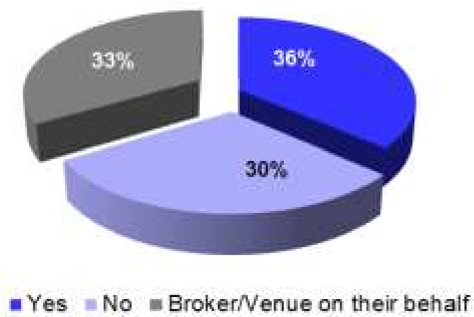
"For less liquid markets such as the Nordics, any restriction on dark trading just makes no sense. Large blocks never trade on-exchange and small and mid-cap stocks will be heavily impacted."
(Large-Sized European Asset Manager)

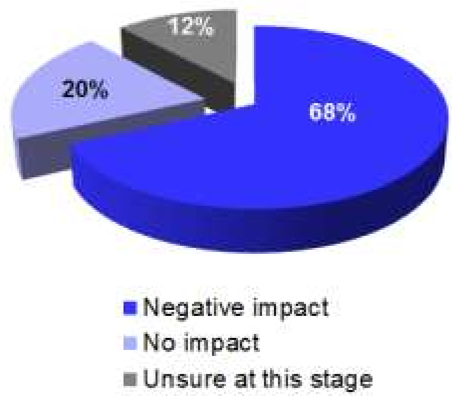
The European Council has put forward a proposal to limit use of the RPW via the use of a volume cap on the amount of business that takes place under the waiver to 4% on an individual venue and 8% across all European venues. The intention is that ESMA "should undertake a comprehensive review of the RPW in order to establish its use is impacting the effectiveness of price formation".

Not all market participants are active users of the waivers, with a proportion reliant on their brokers to use these on their behalf (see exhibit 11). However, the implementation of a volume cap was seen as particularly contentious for small and mid-cap stocks where the impact of removing these waivers would significantly negatively impact the end-client.

This regulation may inadvertently create an additional cause and effect, with volume caps reducing market volumes and therefore efficiency, which in turn will have a materially adverse impact on the ability of investors to confidently take positions in less-liquid names. When including BCS activity reported to Markit BOAT, the threshold already appears to have been exceeded on an aggregate basis in a majority of individual markets.

Exhibits 11 and 12
Current Use of Waivers / The Impact of Volume Caps on the Ability to Trade





Source: TABB Group

> "The volume cap may have a materially adverse impact on the ability of investors to take positions in small and medium-sized enterprises, which should be the purpose of the stock market."
> (Large-Sized UK Asset Manager)

Operational and efficiency considerations must also be considered. Requiring trades to only take place on lit markets will have multiple ramifications for a wider range of low-risk activities, such as risk "unwinds" currently passively executed using BCSs. Restrictions on principle-based crossing also impacts client-based flows on swap and portfolio trading. In addition, there are also practical considerations as to how this will be monitored to ensure compliance with the 8% total volume cap, given the current lack of a consolidated tape.

There will be no change in price on the lit market if two orders on both sides of the order book of equal size are traded. If both trade by sequentially taking the bid and offer, the two counterparties will achieve an average price equivalent to the mid, which is no different from trading a large block away from the lit at the mid national best bid and offer NBBO, and therefore not causing any impact on price formation.

The redefinition of the LIS threshold to a more accurate and calibrated level – perhaps at a percentage of the ADV but with flexibility around the mid-price – could provide a viable alternative.

Looking Overseas

Recent regulatory amendments in Australia and Canada serve as a cautionary tale on how regulation can shift market behaviour from one type of trading venue or order type to another without addressing the underlying transparency concerns.

Australia

The Australian Securities and Investments Commission (ASIC) introduced amendments to its market integrity rules in May 2013 to address concerns about growth in the level of dark trading and its potential impact on market quality. The new rules addressed block trades (Rule 4.2.1) and price improvement (Rule 4.2.3). For block trades, new tiers[3] reduce the size requirements for trades to be executed without pre-trade transparency at any price. Trades that do not meet these size requirements may only be executed without pre-trade transparency if they offer **price improvement (MIR 4.2.3).** This rule replaces the "at or within the spread" exception under Rule 4.2.3 and requires that the transaction is entered into at a price (at the time of execution) that is:

- at a valid price step (that is, tick size) that is both above the best available bid and below the best available offer, or
- at the midpoint of the best available bid and best available offer (where midpoint = (best available bid + best available offer) ÷ 2).

ASIC is attempting to draw a distinction between block trades (where alternative liquidity pools are effective) and non-block trades executed without pre-trade transparency. There is some evidence to suggest that when non-block dark volumes exceed 10%, price formation is harmed. Block trading may indeed not harm price discovery. If anything, it is beneficial to the market to have large block trades negotiated away from the lit central limit order book. Therefore, regulation to constrain alternative liquidity pools needs to be carefully designed to limit the migration of order flow that is beneficial to the lit market, while allowing order flow that does not positively contribute to price discovery (or may even detract from it) to occur in the alternative liquidity pool.

Australian alternative liquidity pool activity before the introduction of the new rules stood at 27% of market volumes. Given the declining activity of overall market volumes it is noteworthy that European alternative liquidity pool volumes stand closer to 10%. MTFs only recently made an appearance in Australia and the market is less developed given the variety and volume of stocks in the European market. Price formation is very heavily dependent on data feeds and there are considerable differences in the levels and availability of data from different regions.

[3] ASIC will publish revised tier allocations on a quarterly basis, starting from June 2013.

Canada

To limit the execution of small orders, Canadian regulators made amendments to the definition of dark orders under the Universal Market Integrity Rules (UMIR). The reasoning behind this appears to be that small, dark orders impaired price discovery and unfairly limited interaction for displayed orders.[4]

The UMIR amendments limit dark order interaction to be either (a) at a "better price" (price improved at least one trading increment or midpoint) or (b) an order of more than 50 standard trading units or having a value of more than C$100,000. The revised definition of "dark order" was designed to provide smaller active (that is, retail) orders the opportunity to receive "meaningful price improvement" and protect small displayed passive orders (although passively displayed orders most often represent high-frequency orders, rather than retail orders).

The outcome proved to be somewhat different. The implementation of the order amendments led to a significant drop in volumes and initially left retail orders incurring higher fees on lit venues. The explicit cost to retail investors has increased by 86%, with active[5] fees of C$0.0004/share at Alpha IntraSpread (or $0.0010/share on MATCH Now) leading to fees of $0.0029/share at Chi-X Global, or $0.0030/share or greater on the Toronto Stock Exchange and TSX Select. In contrast, high-frequency trading participants have benefited from the increase in passive rebate opportunities.

[4] TABB Group, *Canadian Equity Market Structure: Dark Liquidity*
[5] An "Active" order is also known as a "taker" of liquidity.

European Trading: the Issues

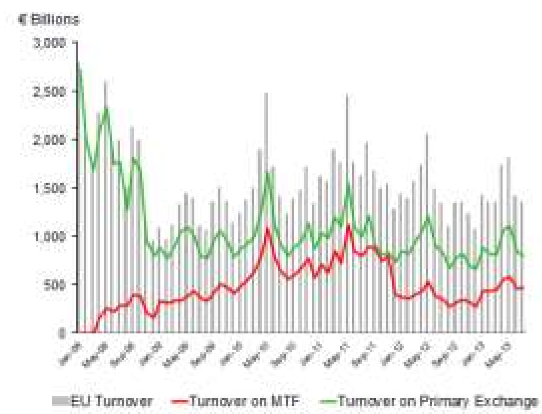
> "I have seen liquidity constantly declining in the last five years. Trading a small cap is very difficult but even trading an order in Royal Dutch Shell or Total – something that used to take no time at all – now can take anything up to an afternoon to execute."
> (Medium-Sized Continental Asset Manager)

As the proportion of automated trading increases, the dichotomy between executing institutional orders and the diminished transparency of algorithmic flow will create challenges for the foreseeable future.

Electronic trading has contributed to a proliferation of execution options, creating competition, which has reduced the cost of trading. However, this is now across a variety of different venues, such as exchanges, MTFs, BCSs and OTFs. While conventional lit markets is now stabilising between the national exchanges and predominantly one MTF (see exhibit 13), contention continues to grow regarding the routing of orders to alternative liquidity pools to limit pre-trade signalling risk.

Prior to electronic trading, stock exchanges provided a venue for corporations to raise financing. Facilitating the buying or selling of stocks was the job of market makers. Access to stock exchanges was expensive, and the market makers were well compensated for their work.

Exhibit 13
Primary versus MTF European Trading Volumes, 2008–2013



Source: Thomson Reuters EMSR/TABB Group

> "Buy-side participants cannot trust the lit while there is such a huge conflict of interests for the exchanges – they are driven by profit-making objectives."
> (Large-Sized Continental Asset Manager)

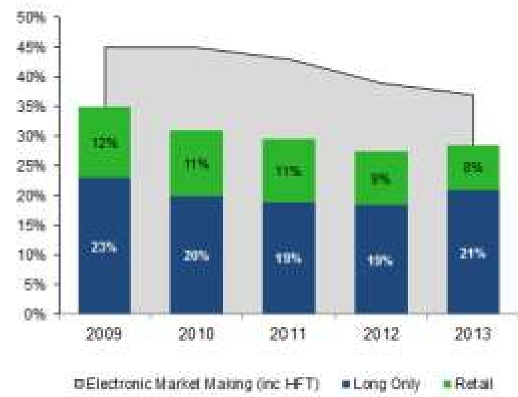
However, as trading has become cheaper and reduced spreads have restricted a market maker's ability to create a profit, exchange costs remain relatively high. High costs together with depleted margins and bank-deleveraging requirements restrict the ability for brokers to offer risk pricing to any other than their top clients. By crossing client order flow internally, BCS enable brokers to net off costs and offer a wider range of clients the ability to continue to trade, economically, efficiently and at reduced risk to their balance sheets.

In addition, electronic market making is also in decline. The combination of increased regulation, underlying market fundamentals and lack of volatility has also played a role in reduced appetite for latency-centric arbitrage strategies, creating a static market for all but the most liquid of names (see exhibit 14).

> "Dark is our ability to source liquidity at the right level. We will be passive if we don't like the price but when the price comes to the right level we can open the gates."
> (Large-Sized UK Asset Manager)

With the fiduciary responsibility of the buy-side trader to ensure best execution yet also execute larger-than-average order sizes, the diminished ability to trade on risk or in size is creating a self-fulfilling prophecy for institutional order flow.

Exhibit 14
Decline in Electronic Market Making versus Rise of the Institutional Investor



Source: Thomson Reuters EMSR/TABB Group

> "I need the liquidity I see in dark pools – especially for small and mid-cap names – to avoid market impact."
> (Nordic Medium-sized Asset Manager)

In the absence of volumes, the institutional investor is forced to turn to greater automation and alternative liquidity sources – and to move away from the main lit exchange – in order to execute order flow. Greater automation on an increased range of venues then requires an increased level of sophistication in technology to determine where and when to trade. As such, buy-side execution will continue to switch to a combination of intuitive algorithms, superior smart order routers (SORs) and intricate venue analysis, which will only propel institutional order flow to further automation and alternative liquidity sources.

Seeking Liquidity

> "We now have access to more liquidity pools that an individual broker does. We no longer need to rely so much on the broker for mainstream trading."
> (Large Global Asset Manager)

Access to liquidity remains the key focus for intuitional investors today, whether they trade using high touch (voice) or low touch (electronic) execution methods (see exhibit 15).

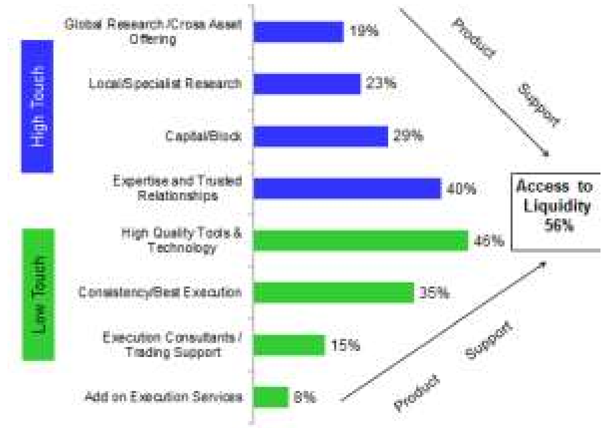
In a bid to attract liquidity, European trading venues are evolving to optimise order pricing and promote innovative execution services. However, there is an inherent conflict of interest.

Buy-side traders now describe sourcing quality liquidity as a "nightmare". When liquidity is good, it can be easy to achieve optimal execution performance; in more challenging markets, it can soon become difficult to see which venues add value and those that do not.

"I need dark pools to find liquidity, particularly in small and mid-cap names. I struggle to execute due to a lack of liquidity. If I can find good liquidity in the dark, I am very happy to use dark pools."
(Large-Sized Continental Fund Manager)

Turnover continues to be impacted by increased regulation, together with higher execution and clearing costs in Europe. Greater emphasis on monitoring fills and routing logic to locate the requisite liquidity from a variety of venues will therefore become even more critical to achieving optimum execution. This is evidenced not only by the rise in accessing alternative venues by institutional investors, but also by the increase in the proportion of order flow they chose to execute.

Exhibit 15
Key Requirements for Institutional Traders



Source: TABB Group

“OTC trading is a helpful way for institutions to execute relatively large orders without excessive market impact.”
(Large-Sized UK Asset Manager)

Dark Differentiation

Understanding the true level of “executable” order flow is vital ahead of any changes to the regulation of alternative liquidity pools. No two pools are the same, just as no two types of trading strategies are the same. Regulation tends to focus on “dark” trading as a single activity, yet there are important distinctions to be made that impact European market structure in a variety of ways.

Exhibit 16
Decline in MiFID OTC Activity, 2008–2013, versus Off-Order-Book Activity

Source: Thomson Reuters EMSR/TABB Group

Over-The-Counter

Traditional “OTC trades” are executed bilaterally off-exchange over the phone as a structured trade between two interested parties – buyer and seller.

“We need greater understanding the level of executable dark. A VWAP trade reported end of the day could be reported OTC – well that is not flow that I could have interacted with. It upsets the figures but has had zero impact on price.”
(Large-Sized UK Fund Manager)

OTC activity as reported to Thomson Reuters has declined from the peak of 54% in May 2011 of €1.3 trillion in turnover to 33.05% or €448 billion in July this year (see exhibit 16). However, this is an extremely opaque market: post-trade data can be hard to obtain and is often unreliable. Volumes are often misconstrued between off-order book activity and the myriad of OTC trading activity, much of which is considered non-executable.

Given the typically large size of voice-OTC executable liquidity there is a growing demand for this to be reported, preferably on a consolidated tape in order to avoid confusion and establish true market activity.

Distorted ADVs impact the cost of risk programme trades and invalidate transaction cost analysis (TCA) reporting. An additional concern is that OTC volume has the potential to be double-counted in a variety of ways:

- Monthly statistics reported to Markit BOAT can also be captured under MTFs category within Thomson Reuters Equity Market Share Reporter (EMSR).
- Markit BOAT can include duplicated prime brokerage volumes.
- Brokers can report both sides of OTC trades if matching two client orders.
- Negotiated trades may not be reported to Markit BOAT, as these are the largest block trades, and has the greatest potential to distort true volumes.

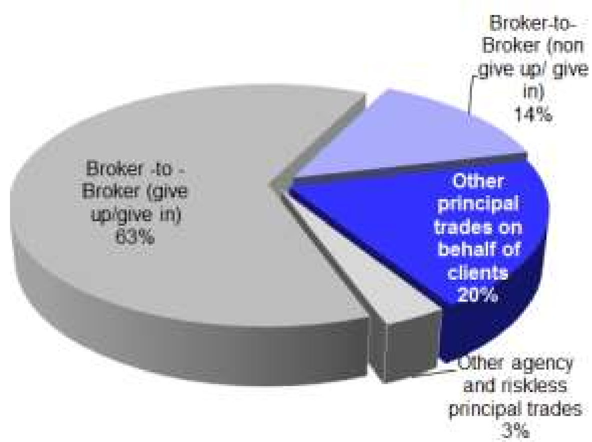
"Confusion over the 40% dark number is not helping. Improvements in the post trade transparency would capture eligible trades and allow market participants to accurately monitor what has been traded where."
(Large-Sized Continental Asset Manager)

Divorcing the Executable

Understanding what constitutes "interactable" liquidity, is an important distinction for understanding the impact of off-exchange trading on European market structure. For example, 35% out of the 45% reported as OTC in the UK market is made up of trades that are reported but do not constitute executable order flow that can be interacted with[6](see exhibit 17), such as:

- **Broker-to-broker (give up/give in):** These are equity hedges associated with CFD trading, whereby the equity is "given up" by the broker who executed the hedge to the OTC provider of the CFD;
- **Broker-to-broker (non give up/non give in): These** include purely technical trades, such as the equity legs of multi-legged derivatives transactions;
- Other principal trades on behalf of clients include the re-printing of already executed trades where the price has been adjusted – for example, the client legs of **guaranteed volume-weighted average price (VWAP)** trades, or the price adjustments of programme trades;

Exhibit 17
Breakdown of UK Non Executable Liquidity



Source: TABB Group

[6] TABB Group, *Effective Spreads in European Equities: A TABB Group Pinpoint*

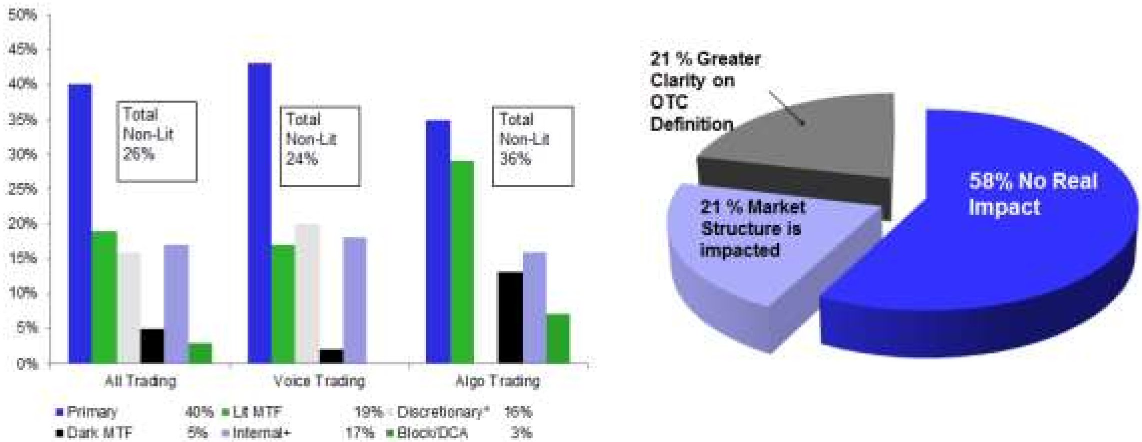
- Other agency and riskless principal trades, where the buy/sell trades are executed at different prices or on different terms and result in two reports to reflect a single trade.

The darkest dark trading is in fact buy-side internal activity that may need to occur internally or externally depending on tax issues or a change in underlying beneficial ownership.

"More work needs to be done to understand the proportions of the different types of OTC and not look at an inaccurate headline figure."
(Large-Sized UK Asset Manager)

One example of a large pan-European asset manager illustrates the variety of trading activity that constitutes "non-lit" activity across both voice and automated trading. While "non-lit" totals 26% of their overall flow (see exhibit 18), there is a distinct difference between the breakdown of the "non-lit" flow depending on whether the order was executed via voice or electronically. With advancements in FIX technology, there are now greater levels of transparency for automated trading versus discretionary flows.

Exhibits 18 and 19
Buy-Side Example of Non-Lit Activity / Impact of OTC Activity on European Market Structure



Source: TABB Group

Crossing off a buyer and a seller at midpoint has no detrimental impact on the underlying price or market volumes. As such, 58% of participants do not see OTC activity as impacting European market structure. Other factors, such as automation and overall turnover decline have had a far greater impact, while a growing number, 21%, would like greater clarity on the definitions of OTC to avoid incorrectly targeting benign trading activity (see exhibit 19).

"It's all about liquidity and improved performance – if I can trade at a better price, it's in the interests of my underlying investors to do so."
(UK-based Fund Manager)

MTF versus BCS

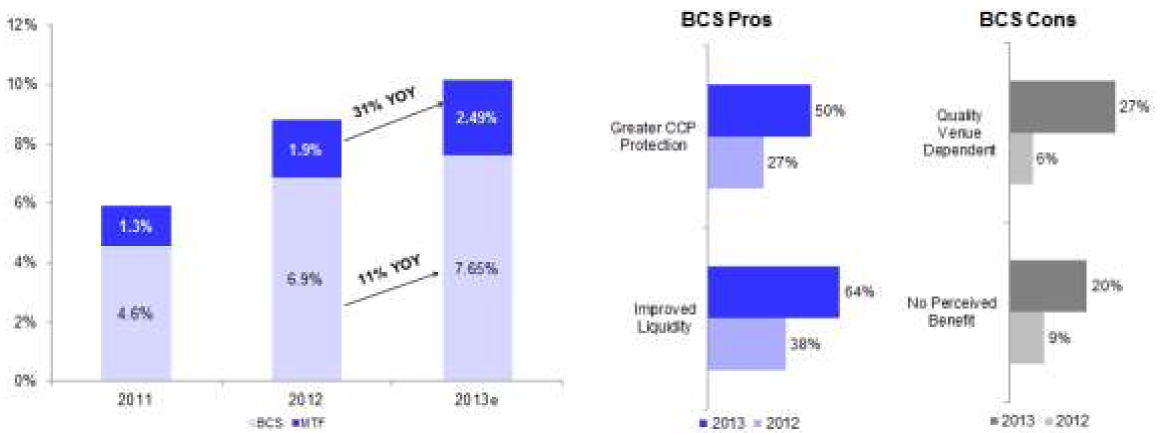
There has been a 31% increase in MTF activity this year versus an 11% increase in BCS (OTF) activity (see exhibit 20). A continued rise in BCS market share is constrained by brokers' ability to cross off customers' buy and sell natural order flow.

"If you are in a dark pool, you are in there for a reason and ought to be prepared to trade at mid."
(Large-Sized UK Asset Manager)

An MTF carries a significantly higher cost than a BCS (OTF), as each MTF is required to have a separate technology stack, plus management, supervision and compliance systems, while the BCS (OTF) costs are factored into the existing trading desk's structure.

Ultimately it is a question of choice. BCS have the ability to ring-fence the participants who can enter the pool, which enables "like for like" order flow to match up, offering a "safer" environment in which to trade. Those participants choosing to access BCS (OTF) activity did so because of greater protection and improved liquidity (see exhibit 21).

Exhibits 20 and 21
Value of BCS 2012 versus 2013 / Increase in Dark MTF Activity 2011–2013(e)



Source: TABB Group

"In the BCS we have a greater level of control which reduces our signaling risk as well as counter-party risk and ultimately improves fund performance particularly in small and mid-cap names."
(Large-Sized Global Asset Manager)

BCSs (OTFs) can include proprietary trading and market-making business with in their volume figures, while MTFs cannot. For the purposes of client facilitation, this can be the difference between the ability to execute an order or not. By mixing proprietary flow and client order flow, clients are provided with the matches they want without incurring the spread on the open market.

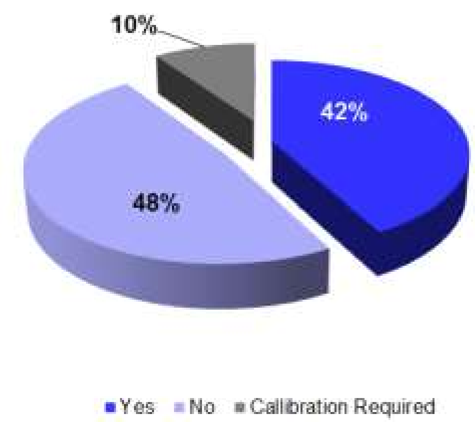
Not all customers are treated the same and this is an important issue. It is this granular level of choice that may yet mean the downfall of the BCS (OTF) model. The multitude of order types and operating rules that have sprung up as a result of brokers attempting to facilitate client requirements obfuscate what kind of orders are interacting with each other and where. There are those on the buy side who see no value in BCS activity, believing that trading off exchange should return to the mid in order to simplify

"Removing the ability for us to post liquidity passively would push execution costs up to the detriment of the underlying investor."
(Large-Sized UK Asset Manager)

trading activity. If a key goal of sourcing alternative liquidity is to minimise the market impact associated with information leakage and visibility on the lit market, executing at midpoint – half way between the bid and the offer price – is clearly "fair" to both sides.

However, market participants remain firmly split on this (see exhibit 22). A slight majority believe the benefits of alternative liquidity pools now extend beyond midpoint pricing: traders should be given the option to cross the spread if they deem it to help achieve best execution.

Exhibit 22
Should Dark Trading Be Limited To Midpoint Execution Only?



Source: TABB Group

Reducing the ability to capture the spread between bid and offer prices has the potential to raise execution costs. Limiting executions to midpoint would lead to lower volumes and wider spreads, reducing the ability to achieve best execution. To not trade at all could mean missing valuable liquidity and in missing trades with second or third-line names, which could have significant consequences for investment selection. Large-cap names can return to the main exchange and increase liquidity at the bid/ask, but smaller cap stocks may be restricted to trading more in mid-tick venues, as was the case in Australia.

The answer may lie between the two with a calibration method around the current waivers in order to protect small and mid-cap liquidity.

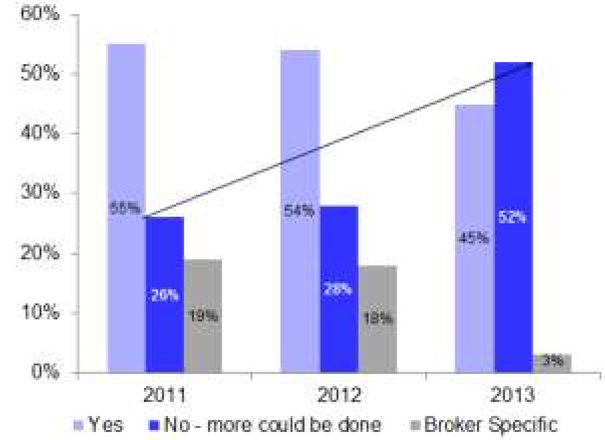
"Trusted venues we understand are rewarded accordingly."
(Large-Sized UK Asset Manager)

Greater Transparency

While trading in alternative liquidity pools is considered an essential option, it does depend on the right venue and paranoia over certain pools has increased. However, with the advancement of FIX tags and venue analysis, automated liquidity pools in comparison to traditional OTC now has a far higher level of post-trade transparency. The irony being that by targeting BCS activity, European regulation may push this latest increased level of transparency back into the shadows.

Fix Protocols tag 30 and tag 851 now offer the opportunity to establish the final execution venue and whether the fill was executed by a liquidity provider or liquidity taker, thereby providing greater assurances as to knowing when, where and with whom they have traded. As such, participants are becoming more selective of where they choose to execute their order flow.

Exhibit 23
Routing Transparency Performance by Brokers 2011-2013e



Source: TABB Group

> “Transparency is improving but there is inconsistency in the TAG 30 codes and data requires cleaning before any meaningful conclusions can be drawn.”
> (Large-Sized European Asset Manager)

Although broker transparency has improved, institutional asset managers are increasingly demanding new levels and a greater scope of data in order to establish their full footprint across the market. As such, venue analysis is no longer broker specific – with the buy side in the driving seat, the sell side know that they benefit from greater disclosure and have significantly improved the level of FIX tag data that they now make available (see exhibit 23).

Ultimately, the rollout of a consolidated tape, together with standardised data reporting, would ensure there was significantly less to fear regarding the levels of OTC activity than the headline number would suggest.

Conclusion

Access to alternative liquidity pools matters for European pension fund managers and small and mid-cap stocks. However forcing prior transparency measures on newly emergent structures merely because they worked in the past cannot be a de facto model for future success.

As the market has evolved and the primary exchange has matured from a national utility to a for-profit model, the underlying interactive market structures have to adapt. Increased market transparency is welcomed by European institutional investors but within a carefully considered and calibrated framework. If regulations are introduced that restrict valuable choice, the outcome of current proposals could be counterproductive and harmful to end-investors. As it stands, increased regulation of alternative liquidity pools will result in equity orders staying on the blotter longer, leading to higher overall trading costs, impacting small and mid-cap stocks in particular.

Reducing turnover or liquidity will only lead to further automation, greater index benchmark trading and increased market-on-close activity. This conversely makes the market more volatile, as volumes are concentrated in certain periods of the trading day. In turn, this plays into greater risk-adverse strategies, creating a requirement for further automation and increased use of alternative liquidity pools in order to limit information leakage ahead of trade execution.

However, there are positive steps that can be taken now to deliver greater transparency without impacting liquidity formation and these should be addressed prior to the implementation of any further regulation of alternative liquidity pools.

The implementation of consolidated tape, constantly discussed but as yet tantalisingly out of reach, is the essential first step. The future design of European market structure and the regulations that lay out their framework must be founded on the basis of accurate and reliable information, distinguishing between interactable and non-interactable liquidity. This will eradicate many of the issues, supposed or real, in the European market today.

With a focus on prevention rather than cure, improved harmonisation of data standards will increase robust monitoring and enable more effective supervision. Automated trading in alternative liquidity pools currently offers greater post-trade transparency through the use of FIX tags that can track the progress of an order throughout the execution. This information can then be used for effective pre-trade venue selection. What will become essential will be to create a similar level of transparency for voice-order execution as that which currently exists for automated trading.

The importance of alternative liquidity pools for small and mid-cap stocks cannot be underestimated. It is easy to say that block trades are good for the market but these are now few and far between. The creation of varying calibration models – together with the need to develop market-specific benchmarks based on spreads and/or volumes to better assess the health of price formation – will be more effective than any blanket legislation.

The retention of the equity OTF category would be advantageous but with limited categories and order types. The simplification of market structure will ensure clarity of the rules and should include standardisation for client facilitation of order flow and restrict onward routing.

Finally, the ability to adapt and react as regulations come into force requires flexibility within technical-based guidelines, preferably introduced within a pilot scheme under the remit of ESMA.

Europe is not alone in struggling to redefine effective market structure. This is a global phenomenon, a direct result of the industrialisation of financial services and the capital markets framework. There are significant global challenges to striking an effective balance between maintaining and facilitating fair and orderly markets, promoting confident and informed investors, yet still facilitating trading activity, all of which are essential for the future development of a sustainable financial services industry. Regulators face a tough task in setting market structure rules and responding to unintended consequences. This task often involves political pressures; succumbing to these can cause a dramatic shift in market structure as we have already witnessed in Europe.

The greater the focus on prevention rather than cure, through improved standardisation of data, the greater the chance of robust monitoring and supervision of markets, which will benefit all market participants – from the pensioner to the fledgling small or mid-cap stock.

Equity trading has been radically transformed in recent years. We cannot return to what was before. However, we can look to improve on what we have currently to create a blueprint for the future. It is essential for the industry to engage in the regulatory process given what is at stake: the responsibility lies with us all.

About

TABB Group

TABB Group is a financial markets research and strategic advisory firm focused exclusively on capital markets. Founded in 2003 and based on the methodology of *first-person knowledge*, TABB Group analyses and quantifies the investing value chain from the fiduciary, investment manager, broker, exchange and custodian. Our goal is to help senior business leaders gain a truer understanding of financial markets issues and trends so they can grow their business. TABB Group members are regularly cited in the press and speak at industry conferences. For more information about TABB Group, visit www.tabbgroup.com.

The Author

Rebecca Healey

Rebecca joined TABB Group in March 2011, bringing more than 15 years' experience in e-trading and financial services. Rebecca has held various sales and trading positions with Bankers Trust, Goldman Sachs, and most recently Credit Suisse, where as Vice President she was instrumental in launching the successful AES (Advanced Execution Services) product to hedge funds from its inception in 2002 until 2008. Prior to this, she was the first electronic trader at Credit Suisse to be registered for all electronic European cash equity markets and covered sales trading into Asia and then Europe between 1997 and 2000. More recently, Rebecca was based in the Middle East from 2008 to 2010. There she was employed by the British Embassy in Bahrain, where she successfully launched the UK Government's financial services strategy and set up the Bahrain Financial Services Roundtable, which remains a key source of information for the UK Government today, especially in relation to Islamic finance. Rebecca holds a Bachelor of Arts degree in Spanish & Latin American History & Politics from the University of London. At TABB Group, Rebecca has authored *European Equity Trends: 2013 Mid-Year Review; One Touch, One World: The Future of Investment Banking; OTC Equity Derivatives: Harnessing the Liquidity; European Equity Trends 2012/13; European Equity Trading 2012/13: Changing the Rules of Engagement; FX in Transition: Taking The Quantum Leap; MiFID II and Fixed-Income Price Transparency: Panacea or Problem?; Market Surveillance in Europe: Under Starter's Orders; European Equity Trading 2011/12: Looking for Allies in the Face of Adversity; European Algorithms: The Evolution; and Trading in the Middle East: the Road to Mecca.*

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